Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1997

ELIZABETH R. COCKRELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The issue to be decided is whether and in what circumstances a fair reading of Section 6013(e)(1)(C) of the Internal Revenue Code imposes an implied duty of inquiry for a non-culpable person to qualify as an innocent spouse; and, if under any circumstances the duty is imposed, whether such duty exists under circumstances where such inquiry would be unreasonable or futile.

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Jay J. Freireich, Esq., on behalf of Petitioner, Elizabeth R. Cockrell, ("Petitioner") petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit ("Second Circuit") in this case.

OPINIONS BELOW

The unpublished Summary Order of the Second Circuit is *Cockrell v. Commissioner of Internal Revenue*, Order #96-4072 (2nd Cir. June 24, 1997). The opinion of the Tax Court in *Crowley v. Commissioner*, is reported at T.C. Memo. 1993-503, ¶ 19,503 (RIA) (1993) ("*Crowley I*") and the Tax Court's Supplemental Memorandum Opinion in the same case is reported at T.C. Memo 1995-551, ¶ 95,551 (RIA) (1995) ("*Crowley II*").

STATEMENT OF JURISDICTION

The judgment of the Second Circuit was entered on June 24, 1997. On September 2, 1997, Justice Ginsburg extended time within which to file a petition for a writ of certiorari to and including November 21, 1997.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

1. Section 6013(d)(3) of the Internal Revenue Code, 26 U.S.C. § 6013(d)(3)[1] provides:

(d) Special rules

(3) [I]f a joint return is made, the tax shall be

1. All section references are to the Internal Revenue Code of 1986 as amended unless otherwise indicated.

computed on the aggregate income and the liability with respect to the tax shall be joint and several.

2. Section 6013(e)(1) provides:

> **(e) Spouses relieved of liability in certain cases.**
>
> **(1) In general**. Under regulations prescribed by the Secretary, if —
>
> (A) a joint return has been made under this section for a taxable year,
>
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,
>
> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
>
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement.
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

3. Section 6013(e)(2) provides:

> **(2) Grossly erroneous Items.** For the purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse —
>
> (A) any item of gross income attributable to such spouse which is omitted from gross income, and
>
> (B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

4. Section 6013(e)(3) provides:

> **(3) Substantial Understatement.** For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6662(d)(2)(A)) which exceeds $500.

5. Section 6662(d)(1)(A) provides:

> **(1) Substantial understatement.**
>
> (A) In general. For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of —
>
> (i) 10% of the tax required to be shown on the return for the taxable year, or
>
> (ii) $5,000.

STATEMENT OF THE CASE

Federal Jurisdiction was vested in the United States Tax Court since this matter is a suit against Respondent for Federal taxes.

Section 6013(e)(1) permits a spouse filing a joint return to be relieved of joint and several liability in certain limited situations. This provision is an exception to the general rule of § 6013(d)(3), which renders each spouse jointly and severally liable for all items reported on their return.

Specifically, the instant case involves the proper construction of § 6013(e)(1)(C). Pursuant to this section, an individual seeking "innocent spouse" relief must not know or have reason to know of grossly erroneous items attributable to the other spouse, the existence of which results in a substantial understatement of tax liability. While no "duty of inquiry" is contained in the statute, courts have imposed a "duty of inquiry" on a spouse before she can meet the "should have known" standard. Petitioner asserts that either: (1) no duty of inquiry should be read into the statute; (2) that the duty of inquiry is only imposed in limited circumstances (not present in the case at bar); or (3) that the duty of inquiry is satisfied under such circumstances as such inquiry would be unreasonable or futile.

The following is a recitation of the relevant facts in this matter. On December 14, 1979, Petitioner and John P. Crowley were married. At that time, Petitioner was a Canadian citizen and Crowley was a United States citizen. Prior to her marriage to Crowley, Petitioner attended the University of Guelph, in Canada, where she received a Bachelor of Arts degree in English. In December 1980, Petitioner was hired as a stockbroker trainee and subsequently passed the "Series Seven" stockbroker examination in the early part of 1981, but had no training or

experience with commodities or straddles. During the time period prior to, and including the years 1980 and 1981 ("the years at issue"), Crowley was a well-known figure in the world of personal financial planning, whose advice regarding tax shelters was frequently sought by highly regarded financial publications.[2]

Crowley was a tax shelter investment promoter who actively marketed and sold investments in commodity straddle transactions involving treasury bill options.[3] These tax shelters were known as Arbitrage Management Tax Sheltered Investments ("Arbitrage"). Crowley was investing in Arbitrage prior to the marriage.

Crowley and Petitioner filed joint income tax returns for the years at issue claiming loss deductions as well as gains stemming from Crowley's premarital investment in Arbitrage.

On June 15, 1981, Petitioner and Crowley signed a joint return for the taxable year 1980, which reported an adjusted gross income of $8,055. This amount was basically comprised of Petitioner's wages of $3,373, Crowley's wages of $7,615 and substantially offsetting gains of $408,097 versus losses of

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2. Crowley was interviewed in Money Magazine and on the television program "Wall Street Week." (Tr. 51).

3. The transactions were in put options, which are options to sell a treasury bill at a particular price, on or before a particular date. The transactions in put options were structured to establish positions known as vertical put spread. A spread is a hedged position comprised of two substantially offsetting options. With a given change in the price of the underlying security, one option will appreciate in value while the other option will depreciate in value. The spread is ordinarily composed of one "long leg" — a purchased option — and one "short leg" — a sold (or granted) option.

$407,884. Most of the gains reported in 1980 were comprised of the gain leg from the 1979 Arbitrage straddle while most of the losses reported in 1980 were comprised of the loss leg from the 1980 Arbitrage straddle. Since the losses and gains substantially offset each other, there was nothing in the 1980 return to put anyone on notice that anything was amiss with the 1980 return.

On January 26, 1983, Petitioner and Crowley signed a joint return for taxable year 1981, and reported an adjusted gross income of $90,658. This amount was basically comprised of Petitioner's wages of $14,190, Crowley's wages of $39,134 and substantially offsetting gains of $697,896 versus losses of $670,327. Most of the gains reported in 1981 were comprised of the gain leg from the 1980 Arbitrage straddle while most of the losses reported in 1981 were comprised of the loss leg from the 1981 Arbitrage straddle. Since the losses and gains substantially offset each other, there was nothing in the 1981 return to put anyone on notice that anything was amiss with the 1981 return.

The loss deductions stemming from Arbitrage were subsequently disallowed by the Internal Revenue Service ("IRS") in a notice of deficiency sent by the IRS to Petitioner and Crowley. All the deductions at issue stem from Crowley's investment in Arbitrage and were promoted by Crowley's firm. Petitioner was not involved in Crowley's Arbitrage investment which began prior to the marriage and never dealt with commodities. She merely assisted in entertaining prospective investors attending seminars organized by Crowley.

Petitioner and Crowley entered into a standard settlement agreement offered by the IRS to all taxpayers involved in Arbitrage which only allowed for a 20% deduction of losses attributable to the commodities straddles for the years at issue.

The agreement left open the issue of whether Petitioner qualified as an "innocent spouse".

No children were born of Petitioner's marriage to Crowley. Petitioner had no involvement in the couple's business and financial affairs. The couple did not live lavishly during their brief marriage. In 1982, Petitioner and Crowley were separated and on August 18, 1983 they were divorced. Petitioner received no assets of any real value in the divorce.

Petitioner claimed to be an innocent spouse pursuant to § 6013(e)(1) for the years at issue in her Petition to the Tax Court. During the Tax Court trial, the attorneys for the Commissioner in the underlying Tax Court case failed to advise the court, or Petitioner's attorney, of critical facts known to them. To wit, the attorneys who were representing the Commissioner against Petitioner in the Tax Court were the very same attorneys who obtained convictions of the promoters of the Arbitrage shelter which gave rise to the substantial understatements in the case at bar. These convictions were not communicated to Petitioner's counsel and were not disclosed to the Tax Court. The existence of the convictions would have been a major factor in Petitioner's case on the issue of whether the tax shelter was grossly erroneous. However, the Tax Court in *Crowley I* held that Petitioner did not qualify as an innocent spouse finding that Petitioner did not offer sufficient evidence to support a finding that the losses were not "grossly erroneous" as defined in § 6013(e)(2)[4] and therefore, Petitioner did not satisfy

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4. A deduction is "grossly erroneous" when it has no basis in fact or law.

> A deduction has no basis in fact when the expense for which the deduction is claimed was never, in fact, made. A deduction has no basis in law when the expense, even if incurred, does

(Cont'd)

§ 6013(e)(1)(B). The court reached this conclusion on the strength of the testimony of Crowley and his associate that the Arbitrage straddles were profit-oriented[5]. Of course, at that time, neither the Tax Court nor Petitioner were aware of the convictions of the shelter promoters.

Following the decision of the Tax Court in *Crowley I*, Petitioner filed a motion for reconsideration pursuant to Tax Court Rule 161, asserting that: (1) newly available evidence established that the losses at issues were "grossly erroneous items" within the meaning of § 6013(e)(2); and (2) that the IRS's conduct in the Tax Court proceeding violated Tax Court Rule 201 and Rule 3.3(a)(5) of the Model Rules of Professional Conduct.

The evidence presented on reconsideration was that during the trial of the instant case, Respondent's counsel, William Blagg, Esq. failed to apprise the court that a partner in Arbitrage, Bernard F. Manko, and Manko's associate, John Edelman, were convicted on February 4, 1991 on multiple counts of Federal income tax fraud in violation of Code Sections 7206(1) and (2) and were also convicted of conspiring to defraud the United

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(Cont'd)

not qualify as a deductible expense under well-settled legal principles or when no legal argument can be made to support its deductibility.

Bouskos v. Commissioner, T.C. Memo. 1987-574 ¶87,574(P-H) (1987); citing Supplemental Report of Comm. On Ways and Means, H. Rept. 98-432 (Part 2), on H.R. 4170 (Tax Reform Act of 1984).

5. In its first published ruling, *Crowley I*, the Tax Court incorrectly ruled that the deductions taken were not grossly erroneous. Upon reconsideration, the Tax Court withdrew its prior ruling and instead ruled on the knowledge aspect without addressing whether or not the deductions were grossly erroneous. *Crowley II*.

States in violation of 18 U.S.C. § 371. They were each sentenced on November 25, 1991 to five years imprisonment and fined $450,000. These convictions were related to the Arbitrage investments marketed and sold after 1981.

Nevertheless, the Court in *Crowley II* concluded that due to the size of the deductions for the years at issue, Petitioner had a "duty to investigate" the deductions. *Crowley II* wrongly concluded that in light of Petitioner's education and career background, she should have known that the loss deductions were erroneous. Accordingly, Petitioner was denied "innocent spouse" relief in this matter. The Tax Court determined the following:

> (A) A deficiency in income tax in the amount of $45,653 and increased interest with respect to the amount of $22,826 under §6621(c) due from Petitioner and Crowley, for the calendar year 1980 in Tax Court Docket No. 28826-84; and
>
> (B) A deficiency in income tax in the amount of $53,911 and addition to the tax under §6651(a) in the amount of $15,123 and increased interest with respect to the amount of $26,500 under §6621(c) due from Petitioner for the calendar year 1981 in Tax Court Docket No. 7746-87.

The Second Circuit in *Cockrell v. Commissioner*, Order #96-4072 (2d Cir. June 24, 1997) affirmed the Tax Court decisions. The Second Circuit ruled that Petitioner had constructive knowledge of the loss deductions. The court concluded that given Petitioner's educational background and work experience she knew or should have learned "through investigation," that the joint returns contained substantial understatements. Therefore, Petitioner was again denied relief as an "innocent spouse."

REASONS FOR GRANTING THE WRIT

The decision of the Second Circuit in the case at bar creates a direct conflict among the circuits concerning the proper construction of § 6013(e)(1)(C). The resolution of this issue is necessary to avoid unnecessary litigation and to bring the circuit courts into conformity. In the absence of a review by this Court, a conflict among the circuits will continue unabated and subject many taxpayers eligible for innocent spouse relief to great hardship. In the absence of a review by this Court, Petitioner, a classic innocent spouse will be required to pay for the misdeeds of her miscreant husband from whom she has been divorced from for over 14 years after a short-lived marriage.

Second, the actions of the IRS in prosecuting the instant case, reveals systematic abuses in the administration of United States revenue laws. This Petition for Writ of Certiorari provides this Court with the opportunity to reaffirm and clarify the rights of taxpayers to be free of such abuse.

I.

THE SECOND CIRCUIT HAS RENDERED A DECISION THAT IS ERRONEOUS AND IN CONFLICT WITH THE DECISIONS OF OTHER CIRCUITS.

A. The Fifth Circuit Correctly Interpreted § 6013(e)(1)(C) In Refusing To Impose A Duty Of Inquiry Where Same Would Be Unreasonable Or Futile.

A recent decision of the Fifth Circuit in *Reser v. Commissioner*, 112 F.3d 1258 (5th Cir. 1997) involved the proper construction of § 6013(e)(1)(C). In *Reser*, 112 F.3d at 1269, the Fifth Circuit reversed a decision by the Tax Court which had denied Mrs. Reser, a licensed attorney, "innocent spouse" status.

The *Reser* court contemplated whether § 6013(e)(1)(C) required an innocent spouse to investigate items attributable to the other spouse where such inquiry would prove futile. In finding in favor of the wife on this issue, the court expressly rejected a construction of § 6013(e)(1)(C) that would create a "duty of inquiry" for Mrs. Reser by holding:

> . . . even if [Mrs.] Reser had conducted further inquiry, she would have gotten responses that corresponded exactly to the information as reported on the 1987 joint report. The Resers' 1987 joint return was prepared by [a] CPA, who concluded that the Resers were entitled to deduct the [shelter] losses. [Mr. Reser] testified at trial that when he filed the 1987 and 1988 joint returns, he believed that he had treated [the shelter] losses correctly in claiming them as deductions. . . .
>
> Had Reser asked [her husband, their accountant or the shelter's accountant] about the deductions, they would have told her what they believed — that [the shelter] losses were properly deductible in full. *Neither the court nor the law will penalize Reser for failing to perform the hollow act of asking questions, the answers to which would have provided no new or different information.*

(Emphasis added).

Thus, the *Reser* court held that there is no duty of inquiry, even to a licensed attorney, where such inquiry would have proved fruitless. In the case at bar, Petitioner, an English major with no experience in sophisticated business dealings, would have uncovered nothing had she asked Crowley, the promoter of the shelter, about the shelter's legitimacy. Burdening

Petitioner with a duty of inquiry would be improper as any inquiries by Petitioner would have proven pointless. Crowley was an active shelter promoter and undoubtedly would have advised Petitioner that the shelter was legitimate. The Second Circuit's finding of a duty of inquiry in Petitioner's circumstances has placed the Second Circuit in direct conflict with the Fifth Circuit. Such a dispute should be resolved by this Court.

B. The Seventh, Eighth, Ninth And Eleventh Circuits Have Correctly Determined That The Duty Of Inquiry Is Only Imposed In Very Limited Circumstances.

The Second Circuit is also in direct conflict with the Seventh, Eighth, Ninth and Eleventh Circuits regarding the duty of inquiry issue.

The Eighth Circuit in *Erdahl v. Commissioner*, 930 F.2d 585, 589 (8th Cir. 1991) established the test to determine whether the knowledge element of § 6013(e)(1)(C) is satisfied in cases involving disallowed deductions. The Eighth Circuit's test, which was adopted from *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989) asks whether a reasonably prudent taxpayer would have known that a deduction would give rise to a substantial understatement in the taxpayer's returns.[6] Significantly, the interpretation of the "did not know, or had no reason to know" language by *Erdahl*, 930 F.2d at 589, and *Price*, only imposes a

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6. The Second Circuit, in *Hayman v. Commissioner*, 992 F.2d 1256 (2d Cir. 1993) has formulated a four-part test to determine if a spouse "had reason to know" pursuant to Section 6013(e)(1)(C). These factors are: (i) the spouse's level of education; (ii) the spouse's involvement in the family's business and financial affairs; (iii) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living and spending patterns; and (iv) the culpable spouse's evasiveness and deceit concerning their finances.

duty on the part of the innocent spouse to investigate reported items attributable to the culpable spouse in the very limited circumstances where she knew "enough facts to put her on notice that an understatement exists." *Price*, 887 F.2d at 590; *Pietromonaco v. Commissioner*, 3 F.3d 1342, 1345 (9th Cir. 1993).

The prerequisite notice for the imposition of a "duty of inquiry" exists only where "the spouse knows sufficient facts such that a reasonably prudent taxpayer in her position would be led to question the legitimacy of the deduction." *Price*, 887 F.2d at 965. Likewise, *Erdahl* only imposed a duty of inquiry where "a reasonably prudent taxpayer *in her position* [would] be led to question the legitimacy of the deduction." (Emphasis in text) *Id.*, 887 F.2d at 591; *Guth v. Commissioner*, 897 F.2d 441 (9th Cir. 1990).

Petitioner, in the case at bar, was not put on notice of such facts as would lead her, in *her* position and with her lack of experience and sophistication, to question the legitimacy of the deductions. Thus, the Second Circuit decision in the case at bar is in direct conflict with the Eighth and Ninth Circuits. The Eighth and Ninth Circuits would not require Petitioner to question the legitimacy of the deductions, since she was unaware of facts which would lead to the need to inquire further.

Furthermore, the Second Circuit decision in *Cockrell* is in direct conflict with the Seventh Circuit in *Resser*[7], 74 F.3d at 1536. The *Resser* Court recently ruled in favor of the spouse on the "should have known" test, stating that in determining whether a spouse "should have known" of a problem with an ostensible deduction,

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7. *Reser*, the Fifth Circuit case, should not be confused with *Resser*, the Seventh Circuit case.

> the court's analysis must focus on whether the spouse had sufficient knowledge of the facts underlying the claimed deductions such that a reasonably prudent person in the taxpayer's position would question seriously whether the deductions were phony.

Resser, 74 F.3d at 1536, citing *Stevens v. Commissioner*, 872 F.2d 1499, 1505 (11th Cir. 1989).

The Seventh Circuit is in conformity with and followed the Eighth and Ninth Circuits in only imposing a duty of inquiry only after it is established that a reasonably prudent wife would seriously question whether the deductions were phony. In the instant action, a reasonably prudent person in Petitioner's position would not have seriously questioned whether the deductions were phony. After all, Petitioner's husband was a highly-reputed shelter promoter who was often quoted in magazines and appeared on television in business news broadcasts, Furthermore, Petitioner did not possess any financial expertise that would impute knowledge to her about the subject shelters.

The Second Circuit decision in *Cockrell* is also in direct conflict with the Ninth Circuit in *Guth*, 897 F.2d at 444-45. *Guth* considered what circumstances create a duty of inquiry in the first instance. In *Guth*, the Ninth Circuit held that it is only when there is "something odd or unusual about the circumstances leading to the understatement that triggers the duty to inquire." Since nothing was odd about the subject deductions in the *Guth* case, the *Guth* court correctly concluded that no duty of inquiry arose.

Identical to the situation in *Guth*, in the case at bar, there was nothing apparently unusual about the subject deductions, nor was it odd that Petitioner lacked knowledge concerning the

tax ramifications of the Arbitrage investments. Petitioner's husband was a shelter promoter, and Petitioner had no expertise in the field.

Finally, the Second Circuit is in direct conflict with the Eleventh Circuit decision of *Kistner v. Commissioner*, 18 F.3d 1521, 1525-27 (11th Cir. 1994). The Eleventh Circuit ruled on when "further investigation is warranted" and determined it was only under limited circumstances. In *Kistner*, the wife lived extremely lavishly[8] and there were significant losses on the return. The court nevertheless held:

> at the time of signing the return, [Mrs. Kistner] could not be expected to know that the tax liability stated was erroneous, *or that further investigation was warranted.*

(Emphasis added). *Id.*, 18 F.3d at 1527.

In the case at bar, Petitioner was not on notice of any understatement and thus no duty of inquiry arose and no further investigation was warranted. A reasonably prudent person *in her position* would not have questioned the legitimacy of the deduction. Petitioner did not maintain a lavish lifestyle during her marriage to Crowley. Furthermore, the subject losses reported by Crowley were not so exaggerated as to put Petitioner on notice of any wrongdoing. Obviously, a prudent person in Petitioner's position would reasonably believe that the promoter of the tax shelter, who is quoted by major publications and on

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8. The wife had a $15,000/mo. allowance; there were purchases of two new Mercedes automobiles in 1979 and 1980; the couple vacationed in Europe; the couple attended horse races throughout the country; the couple employed a full-time maid and gardener; and the couple maintained two homes, one with a clubhouse, swimming pool and tennis court adjacent to it. *Id.*, 18 F.3d at 1525.

television, would not have taken illegitimate deductions. Petitioner was an English major from Canada who had never filed an American joint tax return when she was given the first return to sign. These circumstances militate against imposition of a duty of inquiry since Petitioner was not on notice that anything was awry with the returns.

Accordingly, the errant decision of the Second Circuit in the case at bar is in conflict with the decisions of the Seventh, Eighth, Ninth and Eleventh Circuits in its determination that a duty of inquiry arose in the Petitioner's circumstances at the time that the subject returns were signed.

C. The Second Circuit's Decision In This Case Is Incorrect.

The decision of the Second Circuit in this case is inconsistent with the well-established judicial interpretation of § 6013(e)(1)(C). The Second Circuit's holding would require Petitioner to have scrutinized her joint return, and determine that the subject deductions were not allowable. The Second Circuit erroneously declared that Petitioner was required to ask her husband about the legitimacy of the deductions.

The Second Circuit based its affirmance on Petitioner's failure to meet the standard for "duty of inquiry." The court was of the opinion that Petitioner "failed to ask her husband or anyone else about the legality of the deductions they claimed.[9]"

9. The 1981 return was not prepared by a CPA but rather by a person whom Petitioner believed to be a tax attorney. (Tr. 105). She discussed the commodities straddles at issue with Robert Kraft, Esq. (the alleged tax attorney). She was advised and she believed that a straddle was merely a tax deferral and not a tax avoidance technique. Although Petitioner was aware of the consequences of tax deferral (large tax liability in the final year), she was never advised that there was any question as to the validity of the resulting deductions. (Tr. 100-102). Given the complexity of the transactions and her unfamiliarity with Arbitrage, Petitioner reasonably relied on Mr. Kraft's opinion.

Cockrell, at 2. The Second Circuit determined that this failure constituted willful ignorance[10]. Yet, the court failed to recognize two points: (1) the duty of inquiry only arises when Petitioner is on notice of facts leading to the understatement; and (2) even if a duty of inquiry were to be imposed, her husband, being the promoter of the tax shelter in question, would undoubtedly have responded that the deductions were legitimate. Certainly, the promoter of the shelter would not have told his wife that the deductions taken were not proper. Crowley had testified in the Tax Court that the losses taken were legitimate. The Second Circuit thus neglected to understand, as the Fifth Circuit in *Reser* did, that

> neither the court nor the law will penalize [a taxpayer] for failing to perform the hollow act of asking questions, the answers to which would have provided no new or different information.

Reser, 112 F.3d at 1269.

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10. The Second Circuit's belief that an innocent spouse's failure to review a joint return, without more, meaning she "should have known," was rejected by the Seventh Circuit in *Resser v. Commissioner*, 74 F.3d 1528 (7th Cir. 1996). "The fact that she signed the return without reading it does not require the conclusion that she had reason to know. . ." *Resser*, 74 F.3d at 1539.

See also Epstein v. Commissioner, T.C. Memo 1996-239 (RIA) ¶96,239; finding innocent spouse relief where the husband sold tax shelters:

> In the era that encompassed the years 1976-1978, individuals far more financially sophisticated than Petitioner let themselves believe [that] tax shelters would bring them substantial wealth, at little or no cost to themselves. . .

We, therefore, hold that Petitioner had no reason to know that the returns for the relevant years contained substantial understatements of tax.

In summary, the holding of the Second Circuit in the present case directly conflicts with the recent decision of the Fifth Circuit in *Reser* under which certain circumstances obviate the duty of inquiry, *i.e.* futility of inquiry. The decisions in the two circuits were issued approximately one month apart yet are strikingly contradictory. Additionally, the holding of the Second Circuit in the instant matter directly conflicts with the decisions of the Seventh, Eighth, Ninth and Eleventh Circuits regarding the circumstances that trigger a duty of inquiry in the first place. The questions addressed in these cases have substantial importance in the administration of the Internal Revenue Code and may affect numerous taxpayers' liability for taxes rightfully attributable only to their spouses.

D. The Second Circuit's Decision Is Contrary To Legislative Intent — I.R.C. § 6013(e)(1).

It is clear that the legislative intent behind I.R.C. § 6013(e)(1) contradicts the Second Circuit's interpretation of said provision. "The innocent spouse provision was enacted by Congress to remedy grave injustices." *Bliss v. Commissioner*, 59 F.3d 374, 378 (2d Cir. 1995) quoting *Hayman v. Commissioner*, 992 F.2d 1256, 1259 (2d Cir. 1993). "In order to effectuate the stated legislative intent, § 6013(e)(1) should be construed and applied *liberally* in favor of the person claiming their benefits." (Emphasis added). *Friedman v. Commissioner*, 53 F.3d 523, 528-29 (2d Cir. 1995); *See also Bliss*, 59 F.3d at 378. Section 6013(e)(1) was enacted to

> correct unfair prior case law that held innocent spouses liable for the tax consequences of their partners' misdeeds, and "to bring government tax collection practices into accord with basic principles of equity and fairness."

Bliss, 59 F.3d at 380 (Oakes, J., dissenting); *See also* H.R. Rep. No. 1734, 91st Cong. 2d Sess. 2 (1970).

The Tax Court in the case at bar, *Crowley II* at n.18, indicated that there was such an injustice to Petitioner and it "sympathize[d] with [Petitioner's] plight" but nevertheless felt constrained to deny "innocent spouse" relief. The Second Circuit, in affirming the Tax Court's opinion, completely disregarded the remedial nature and intent of § 6013(e).[11] The Second Circuit's decision in *Cockrell*, rather than ameliorating the harsh consequences of joint and several liability, penalized Petitioner and similarly situated innocent spouses who will be bound by this unfortunate precedent, which is contrary to the Legislative intent.

E. The "Innocent Spouse" Provision Is In A State Of Flux And Needs Clarification.

Abuse by the IRS has recently come under fire stemming from Senate hearings uncovering horrific mistreatment of taxpayers by the IRS. The House of Representatives signed a Bill and presented it to the Senate for consideration (the "House Bill")[12] which calls for sweeping changes in the manner in which the IRS will be allowed to treat taxpayers. Furthermore, the House Bill will add checks and balances to the administration of the Internal Revenue Code.

Following many years of inconsistent rulings by the courts

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11. As explained by the Fifth Circuit: "Section 6013(e) is a remedial statute. Its sole purpose is to remedy, in certain circumstances, the inequities . . . of joint liability." *Allen v. Commissioner*, 514 F.2d 908, 915 (5th Cir. 1975)

12. H.R. 2292, to be known as the "Internal Revenue Service Restructuring and Reform Act of 1997."

in deciding cases construing the "innocent spouse" provisions, the House of Representatives sent the House Bill to the Senate and proposed to once again broaden the innocent spouse law which Congress initially enacted in 1971[13] and had subsequently broadened in 1984[14]. The House Bill broadens the categories of situations in which innocent spouse relief will be afforded by removing some of the hurdles contained in § 6013(e).

The House Bill calls for deleting § 6013(e) and adding a new section to the Internal Revenue Code as follows:

Section 6015. Innocent Spouse Relief; Petition to Tax Court.

(a) Spouse Relieved of Liability in Certain Cases. —

(1) In General. — Under procedures prescribed by the Secretary, if —

(A) a joint return has been made under Section 6013 for a taxable year,

(B) on such return there is an understatement of tax attributable to erroneous items of 1 spouse,

(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such understatement,

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13. Act of Jan. 12, 1971, Pub. L. No. 91-679, 84 Stat. 2063.

14. Section 424(c) of the Deficit Reduction Act of 1984 provides for retroactive application of the amendments permitting innocent spouse relief to disallowed deduction cases for all open years. H.R. Rep. No. 98-432, 98th Cong., 2d Sess., pt. 2, at 1503, *reprinted in* 1984 U.S. Code Cong. and Admin. News 697, 1144.

> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such understatement, and
>
> (E) the other spouse claims (in such form as the Secretary may prescribe) the benefits of this subsection not later than the date which is 2 years after the date of the assessment of such deficiency,
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties and other amounts) for such taxable year to the extent such liability is attributable to such understatement.

The requirements found in the current law that the understatement of tax be "substantial" and that such understatement be "grossly erroneous" are conspicuously absent from the House Bill.

Although the changes currently being considered by Congress will affect taxpayers prospectively[15], there are many "innocent spouse" taxpayers affected by the current law. This Court's determination of this important issue for innocent spouses will also have prospective effect even if the House Bill is enacted, since the "knew or should have known" language at issue in the case at bar is still contained in the House Bill.

The questions for consideration in the case at bar and not amended by the House Bill is the construction of the phrase: "the spouse knew or should have known," whether and in what

15. The current version of the House Bill provides for that it is only effective for taxable years beginning after the date of the enactment of the Act. Section 321(e) of the House Bill.

circumstances there is an implicit "duty of inquiry" therein and under which circumstances it is obviated.

Even if there is a "duty of inquiry," the circuits have differed on whether to invoke a "duty of inquiry" where such inquiry would not have uncovered any errors. *See* Point I, *supra*.

The House Bill attempts to redress these inconsistencies in favor of the non-culpable taxpayer. The courts are left with the responsibility to construe the language of the existing law and to do so broadly. Unfortunately, the Second Circuit has taken an unduly restrictive reading of § 6013(e) in direct conflict with other circuits. Such a reading should not be allowed, and therefore, this Court should remediate the situation by granting *certiorari*.

II.

THE ABHORRENT IRS PRACTICES IN THE CASE AT BAR REQUIRE THAT THIS CASE BE REVIEWED.

Petitioner respectfully requests *certiorari* because this case presents this Court with the opportunity to provide much needed judicial review of the abhorrent practices of the IRS.

A review of the legality of IRS activities is especially timely in light of the recent testimony before the Senate Finance Committee. The hearings outlining the abuses of the IRS illustrated a fundamental distrust of the agency by a large segment of the United States Population. In this regard, Sen. William V. Roth, Jr., Chairman of the Senate Finance Committee, stated:

> The stories told by the taxpayers and agents at our hearing were not just anecdotes; they revealed a larger

> problem deeply rooted in the agency — a problem that will not yield to a quick fix. These hearings have hopefully been a wake up call for the IRS. The flood of phone calls, faxes and e-mails to my office in the past week shows that Americans are paying attention and expect results. Where appropriate, we will be taking legislative action. Statement Sen. William V. Roth, Jr., Chairman, Senate Finance Committee.
>
> Associated press, September 30, 1997 — Congressional Press Release.

It is well settled that the judiciary stands as a bulwark against governmental intrusion on civil liberties. The prosecutorial misconduct that the IRS employed during this case was not an isolated incident or an aberration. As the Senate testimony illustrates, taxpayers are often at the mercy of overzealous IRS employees who place their professional advancement above ethical and legal principles. The IRS conduct in the Tax Court violated well settled ethical norms and raises serious questions about the administration of United States revenue law. The IRS asserted in the Tax Court that the deductions taken by Crowley in 1980 and 1981 were not "grossly erroneous" as defined in § 6013(e), while at the same time prosecuting and procuring convictions of the shelter organizers of tax fraud in connection with Arbitrage. Were this Court not to review this egregious practice, it would tacitly countenance the practice at the expense of an innocent Petitioner whose rights and liberties were trampled.

In *Crowley I*, the Tax Court erroneously ruled that the deductions were not grossly erroneous. At that time, the Tax Court was unaware of the convictions of the shelter promoters (since the IRS failed to so apprise the Tax Court). However, the IRS attorneys representing the Commissioner in the Tax Court

were well aware of the convictions, as they were the prosecuting attorneys of Manko and Edelman. After Petitioner's counsel learned of the convictions through independent sources and brought Petitioner's Motion for Reconsideration to the Tax Court, the Tax Court merely withdrew its prior ruling. The Tax Court disallowed Petitioner relief by ruling against her on the knowledge issue without even addressing whether the deductions were grossly erroneous. *Crowley II*.

IRS Counsel deliberately failed to disclose highly probative evidence concerning the illegitimacy of the loss deductions. Bernard F. Manko, a partner of Crowley, and John Edelman, Manko's associate, were convicted on February 4, 1991 on multiple counts of federal income tax fraud in violation of § 7206(1) and (2) and also convicted of conspiring to defraud United States in violation of 18 U.S.C. § 371. The Second Circuit in *United States v. Manko*, 979 F.2d 900, 904 (2nd Cir. 1992) affirmed these convictions and described these transactions as involving "typing, not trading." The court stated that there was "powerful evidence that the purported transactions were shams that never took place." *Id*. The convictions of Manko and Edelman involved fraudulent and fictitious treasury bill transactions similar in nature to those involved in the instant case. The 1980 and 1981 transactions in the case at bar were part of the same tax shelter program as those involved in the convictions.

IRS Counsel in the instant action were the same counsel involved in the criminal prosecution of Manko and Edleman. However, IRS Counsel did not disclose the convictions to Petitioner or the court when cross examining Mr. Sinclair, a partner of Crowley at Arbitrage, regarding its operation. Respondent's counsel had a duty under the Tax Court Rule 201(a) and Model Rules of Professional Conduct of the American Bar Association to disclose this information. RPC.

3.3(a)(5) prohibits a lawyer from "knowingly fail[ing] to disclose to the tribunal a material fact with knowledge that the tribunal may tend to be misled by such failure." The fact that the shelter promoters were convicted in connection with the Arbitrage investment, albeit in a later year, was directly adverse to the Commissioner's position that the disallowed Arbitrage deductions were not grossly erroneous.

In the past few months, the topic of IRS abuses inflicted against taxpayers has been discussed almost daily in the media. The Senate hearings on these IRS abuses have taken center stage and have captivated this country. Following the litany of horror stories by taxpayers (and even IRS agents) that were told to the Senate, taxpayers have demanded widespread changes in the administration of Internal Revenue Code. President Clinton has issued a statement calling for changes. The House put forth the House Bill which calls for an Oversight Board composed primarily of persons from the private sector to oversee IRS practices. In the wake of this controversy, the IRS has convened to discuss how to avoid the widespread abuses that have led to the public furor.

While the legislative and executive branches have spoken on this topic, this case gives the judicial branch an apt opportunity to denounce IRS abuse of taxpayers.

In summary, Petitioner requests that this Court make clear that this type of unfair practice by the agency entrusted with the administration of United States revenue law is both unethical and violates all notions of due process.

III.

THE SUPREME COURT SHOULD CONSIDER THE "INNOCENT SPOUSE" ISSUE NOW, AS THE ISSUE IS RIPE.

It is now an opportune time for this Court to consider an innocent spouse tax case. Petitioner's case involves not only an occasion for this Court to determine the liberality with which the courts should construe innocent spouse laws, but it also involves an opportunity to review a case of IRS abuse committed against Petitioner. As such, it is the quintessential innocent spouse case for this Court to consider.

The unfair overzealousness by the IRS attorneys in attempting to defeat Petitioner at all costs is precisely the type of abuse that is so abhorrent in this country. By granting *certiorari* in this case, this Court would have the opportunity to castigate the unfair tactics committed by the IRS.

CONCLUSION

In the absence of the resolution of the conflict among the circuits, the tax consequences to spouses will vary based solely on geographical happenstance. Resolution of this important question is needed to avoid continuing uncertainty and to assure even-handed application of the revenue laws throughout the country. This petition for a Writ of Certiorari should therefore be granted.

Respectfully submitted,

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APPENDIX A — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT FILED JUNE 24, 1997

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

THIS SUMMARY ORDER WILL NOT BE PUBLISHED IN THE FEDERAL REPORTER AND MAY NOT BE CITED AS PRECEDENTIAL AUTHORITY TO THIS OR ANY OTHER COURT, BUT MAY BE CALLED TO THE ATTENTION OF THIS OR ANY OTHER COURT IN A SUBSEQUENT STAGE OF THIS CASE, IN A RELATED CASE, OR IN ANY CASE FOR PURPOSES OF COLLATERAL ESTOPPEL OR RES JUDICATA.

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 24th day of June, one thousand nine hundred and ninety-seven.

PRESENT:

HON. JOHN M. WALKER, JR.,
HON. GUIDO CALABRESI,
HON. DONALD P. LAY,
*Circuit Judges.**

ELIZABETH COCKRELL,

Petitioner-Appellant,

v.

The Honorable Donald P. Lay, Senior Judge of the United States Court of Appeals for the Eighth Circuit, sitting by designation.

Appendix A

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ORDER
96-4072

Appearing for Appellant: Jay J. Freireich, Poe & Freireich, Florham Park, N.J.

Appearing for Appellee: Jonathan S. Cohen, Tax Division, Department of Justice, Washington, D.C.

UPON CONSIDERATION of this appeal from decisions of the United States Tax Court (Wells, *J.*), it is hereby

ORDERED, ADJUDGED, AND DECREED that the decisions be and they hereby are

AFFIRMED.

Elizabeth Cockrell appeals from decisions of the United States Tax Court (Thomas B. Wells, *Judge)* entered February 29, 1989 determining a deficiency in income taxes for Cockrell and her former husband, John P. Crowley, for the tax year 1980, and a deficiency for Cockrell for the tax year 1981. In its Memorandum Opinion, filed November 1, 1993, *see Crowley v. Commissioner*, 66 T.C.M. (CCH) 1180 (1993), and its Supplemental Memorandum Opinion, filed November 20, 1995, *see Crowley v. Commissioner,* 70 T.C.M. (CCH) 1374 (1995), the tax court rejected Cockrell's argument that she is entitled to relief from these deficiencies under I.R.C. § 6013(e), which

provides an exception to joint and several liability for those who can establish innocent spouse status.

Cockrell argues on appeal that the tax court erred in finding that she did not meet the requirements for relieving innocent spouses of liability. In particular, she contends that she has demonstrated (1) that the deductions that caused the understatement were "grossly erroneous items"; (2) that "she did not know, and had no reason to know, that there was [a] substantial understatement" in the joint returns she signed with her former husband; and (3) that it is inequitable to hold her liable for the deficiencies. *See* I.R.C. §§ 6013(e)(1)(B), 6013(e)(1)(C), 6013(e)(1)(D). In order to qualify for innocent spouse status, Cockrell must prove all of these elements. *See Hayman v. Commissioner,* 992 F.2d 1256, 1260 (2d Cir. 1993).

Although Cockrell claims to have signed the returns at issue without reading them, "she nevertheless is charged with constructive knowledge of their contents." *Id.* at 1262. Furthermore, "large deductions, such as tax shelter losses offsetting income from other sources and substantially reducing or eliminating the couple's tax liability, generally put a taxpayer on notice that the tax return may contain substantial understatements." *Friedman v. Commissioner,* 53 F.3d 523, 531 (2d Cir. 1995) (internal quotation marks omitted). The tax returns Cockrell signed included large deductions of this sort. In 1980, for example, a gain of $408,097 was offset by a loss of $407,884. The return reported adjusted gross income of only $8,055 and a tax due of $240. Yet, despite this indication that the tax returns might contain substantial understatements, Cockrell took no steps to fulfill even the most minimal "duty to enquire as to the propriety of" the tax shelter deductions. *Id.* She failed to ask her husband or anyone else about the legality of the deductions they claimed.

Appendix A

Cockrell was college-educated, had passed the "series seven" examination for stockbrokers, and worked as a stockbroker trainee. She was involved, albeit in a limited way, in her husband's business, since she attended seminars with him, attempted to attract clients for her husband, and entertained clients at home. Cockrell and Crowley lived lavishly during 1980 and 1981. And there is no evidence that Crowley was evasive or deceitful about their finances in general or about the commodities straddle transactions that served as the basis for the tax shelters in particular. All of these factors suggest that a prudent taxpayer in Cockrell's position could be expected to know or reasonably to be able to ascertain that the returns she signed may have contained substantial understatements. *See Hayman*, 992 F.2d at 1261 (citing *Price v. Commissioner*, 887 F.2d 959, 965 (9th Cir. 1989)).

Accordingly, we hold that there were ample grounds for the tax court to conclude that Cockrell had "reason to know" that the deductions would give rise to a substantial understatement and that its findings of fact are not clearly erroneous. Since Cockrell's failure to establish *any* element required by Section 6013(e) is a sufficient basis for denying her innocent spouse status, we need not address the other elements of the section.

We have examined all of Cockrell's contentions and found them to be without merit. The tax court's decisions are affirmed.

s/ John M. Walker, Jr.
Hon. John M. Walker, Jr.

s/ Guido Calabresi
Hon. Guido Calabresi

s/ Donald P. Lay
Hon. Donald P. Lay

Circuit Judges.

APPENDIX B — DECISION OF THE UNITED STATES TAX COURT ENTERED FEBRUARY 29, 1996

UNITED STATES TAX COURT

Docket No. 7746-87

ELIZABETH R. COCKRELL,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinions of the Court filed November 1. 1993 and November 20, 1995, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1981 in the amount of $53,911.00;

That there is an addition to tax due from the petitioner for the taxable year 1981, under the provisions of I.R.C. § 6651(a), in the amount of $15,123.00;

That there are no additions to tax due from the petitioner for the taxable year 1981, under the provisions of I.R.C. §§ 6653(a)(1) and 6653(a)(2); and

Appendix B

That for the taxable year 1981, $26,500.00 is a substantial underpayment attributable to tax-motivated transactions, for purposes of computing the interest payable with respect to such amount, pursuant to I.R.C. § 6621(c).

(Signed) Thomas B. Wells
Judge.

Entered: FEB 29 1996

* * * * *

The parties stipulate that the foregoing decision is in accordance with the opinions of the Court and the respondent's computation, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein.

APPENDIX C — SUPPLEMENTAL MEMORANDUM OPINION OF THE UNITED STATES TAX COURT FILED NOVEMBER 20, 1995

T.C. Memo. 1995-551

UNITED STATES TAX COURT

JOHN P. CROWLEY AND ELIZABETH R. COCKRELL, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent*

Docket Nos. 28826-84, 7746-87. Filed November 20, 1995.

Stanley M. Klein, and *Michael J. Weitzner*, for petitioner John P. Crowley in docket No. 28826-84.

Alan J. Garfunkel, Marc S. Orlofsky, and *Edward Rubin*, for petitioner Elizabeth R. Cockrell in docket Nos. 28826-84 and 7746-87.

Drita Tonuzi and *Henry S. Schneiderman*, for respondent.

SUPPLEMENTAL MEMORANDUM OPINION

WELLS, *Judge*: These cases[1] are before us on petitioner Elizabeth R. Cockrell's[2] motion pursuant to Rule 161[3] for

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* This Supplemental Memorandum Opinion supplements our prior Memorandum Opinion in the instant case, *Crowley v. Commissioner*, T.C. Memo. 1993-503, filed November 1, 1993.

1. These cases (for convenience, hereinafter referred to as the instant case) have been consolidated for trial, briefing, and opinion.

2. As petitioner John P. Crowley has settled all issues in the instant case with respect to himself, hereinafter we will refer to Elizabeth R. Cockrell as "petitioner" and John P. Crowley as Mr. Crowley.

3. Unless otherwise indicated, all Rule references are to the Tax (Cont'd)

reconsideration of *Crowley v. Commissioner*, T.C. Memo 1993-503 (prior Opinion) In our prior Opinion, we held, inter alia, that petitioner was not entitled to relief under section 6013(e) as an innocent spouse from the understatements of tax for her taxable years 1980 and 1981 attributable to deductions claimed for losses incurred by Mr. Crowley in connection with certain commodities straddle transactions That holding was based on petitioner's failure to prove that such understatements of tax were attributable to "grossly erroneously items" pursuant to section 6013(e)(2)(B).[4]

Background

In her motion, as supplemented, petitioner requests, inter alia, that we reconsider our prior Opinion and either decide that she qualifies for relief as an innocent spouse based on the evidence already in the record or reopen the record to allow introduction of additional evidence in support of her claim that she qualifies for relief as an innocent spouse. Petitioner's requests are based on the following contentions: (1) That newly

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(Cont'd)
Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the years in issue.

4. Because the requirements for relief as an innocent spouse under sec. 6013(e) are conjunctive, *Bokum v. Commissioner*, 94 T.C. 126, 138 (1990), affd. 992 F.2d 1132 (11th Cir. 1993), our holding that such deductions were not attributable to "grossly erroneous items" rendered it unnecessary for us to decide whether petitioner satisfied the other requirements of that subsection that were contested by petitioner and respondent (viz: (1) In signing the returns in issue petitioner did not know and had no reason to know of the existence of the understatements in issue and (2) it would be inequitable to hold petitioner liable for the deficiencies resulting from those understatements).

available evidence establishes that the deductions in issue are "grossly erroneous items" within the meaning of section 6013(e)(2); (2) that respondent's counsel at the trial of the instant case violated Rule 201 and rule 3.3(a)(3) of the Model Rules of Professional Conduct (Model Rules) in not disclosing certain information petitioner alleges is relevant to that question; and (3) that petitioner is entitled to relief as an innocent spouse pursuant to the transitional rule of section 6004 of the Technical and Miscellaneous Revenue Act of 1988 (TAMPA), Pub. L. 100-647, 102 Stat. 3685-3686 (transitional rule).[5]

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5. The transitional rule provides as follows:

Sec. 6004. TREATMENT OF CERTAIN INNOCENT SPOUSES

Subsection (c) of section 424 of the Tax Reform Act of 1984 (relating to innocent spouse relieved of liability in certain cases) is amended by adding at the end thereof the following new paragraph:

"(3) Transitional Rule. — If —

"(A) a joint return under section 6013 of the Internal Revenue Code of 1954 was filed before January 1, 1985,

"(B) on such return there is an understatement (as defined in section 6661(b)(2)(A) of such Code) which is attributable to disallowed deductions attributable to activities of one spouse,

"(C) the amount of such disallowed deductions exceeds the taxable income shown on such return,

"(D) without regard to any determination before October

(Cont'd)

Appendix C

Although we incorporate into this Opinion by reference the findings of fact in our prior Opinion, we restate below certain of those findings that are relevant to the issues presented by petitioner's motion for reconsideration, and we further set forth certain supplementary findings of fact that were not set forth in our prior Opinion but are, however, based on the record of the trial of the instant case and relevant to our analysis below.

On November 14, 1979, petitioner and Mr. Crowley were married. At that time, petitioner was a Canadian citizen and Mr. Crowley was a U.S. citizen. They were married in a New York civil ceremony. On November 17, 1979, petitioner and Mr. Crowley were married a second time in a Canadian church. Prior

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(Cont'd)

21, 1988, the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such an understatement, and

"(E) the marriage between such spouses terminated and immediately after such termination the net worth of the other spouse was less than $10,000,

notwithstanding any law or rule of law (including res judicata), the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such understatement, and, to the extent the liability so attributable has been collected from such other spouse, it shall be refunded or credited to such other spouse. No credit or refund shall be made under the preceding sentence unless claim therefor has been submitted to the Secretary of the Treasury or his delegate before the date 1 year after the date of the enactment of this paragraph, and no interest on such credit or refund shall be allowed for any period before such date of enactment". [Emphasis added.]

to her marriage to Mr. Crowley, petitioner attended the University of Guelph, in Canada, where she received a bachelor of arts degree. From August 1977 until August 1979, petitioner worked in Canada as a life insurance agent first for Prudential Assurance and then Montreal Life Insurance.

Shortly after the marriage ceremony in Canada, petitioner and Mr. Crowley returned to New York. During 1980, petitioner worked for a photographer in New York City for 1 week in exchange for learning about photography. For 2 weeks, she solicited, by telephone, on behalf of a messenger service located in New York City, for which she was compensated approximately $200.

During December 1980, petitioner was hired as a stockbroker trainee in New York. In order to prepare for the "series seven" stockbroker examination required for her employment, petitioner studied about stocks and bonds at home. Prior to passing the exam, petitioner answered the telephones for her employer. During the early part of 1981, petitioner passed the exam and obtained her stockbroker license. Subsequently, petitioner "cold-called" potential clients to sell them stocks and bonds. Neither petitioner's studies nor her work specifically included commodities tax straddles.

During the years in issue, Mr. Crowley was a partner in TSM Associates, Sinclair Securities Company, and APEX Associates, which were partnerships that had engaged in commodities straddle transactions involving Treasury bill options. Mr. Crowley, as an employee in James Sinclair Trading Corporation, arranged commodities straddle transactions for investors seeking "taxsheltered investments".

Appendix C

Petitioner was aware of Mr. Crowley's position as a "commodities trader". Petitioner accompanied Mr. Crowley at several commodities seminars during which she "milled about" at the back of the room, "drifted" in and out of the seminar rooms, and socialized with other wives attending the seminars. Petitioner attempted to attract clients for her husband at the hospitality suites provided by Mr. Crowley's employer after those seminars. Petitioner, however, did not discuss commodities straddle transactions during the seminars or in the hospitality suites.

When petitioner and Mr. Crowley were first married, they rented a one-bedroom apartment in Manhattan. During their marriage, petitioner and Mr. Crowley regularly entertained Mr. Crowley's clients at their apartment, and they frequently dined out at expensive restaurants in Manhattan. During 1980, Mr. Crowley and petitioner took vacations to Canada, Vermont, and Florida. Mr. Crowley's American Express bill for that year was approximately $90,000, and a substantial portion of that amount was charged by petitioner. During 1981, they moved to a two bedroom apartment which they rented for approximately $1,400 or $1,500 per month and garaged Mr. Crowley's BMW automobile for approximately $250 to $300 per month. Subsequently, they rented a ranch house on Long Island.

During 1982, petitioner and Mr. Crowley decided to separate. After their separation, petitioner moved into a small loft apartment and paid the security deposit with $2,000 which Mr. Crowley had given her. On August 18, 1983, petitioner and Mr. Crowley were divorced.

On June 15, 1980, petitioner and Mr. Crowley signed a joint tax return for taxable year 1979, which was filed on June 24,

1980, and reported a negative adjusted gross income in the amount of $71, 312. During 1979, Mr. Crowley earned $81,925 in commissions from the James Sinclair Trading Corporation. On June 15, 1981, petitioner and Mr. Crowley signed a joint tax return for taxable year 1980, which was filed before the end of the month, and reported an adjusted gross income of $8,055 and tax due of $240. During 1980, Mr. Crowley earned $122,683 in commissions from Sinclair Securities Company. On January 26, 1983, petitioner and Mr. Crowley signed a joint tax return for taxable year 1981, which was filed on January 31, 1983,[6] and reported an adjusted gross income of $90,658 and tax due of $13,980. During 1981, Mr. Crowley earned $148,141 in commissions from Sinclair Securities Company. Petitioner signed the joint returns for 1979, 1980, and 1981 without reviewing them.

The losses disallowed in the notices of deficiency were claimed by petitioner and Mr. Crowley on their 1979, 1980, and 1981 joint tax returns as Mr. Crowley's share of losses incurred by TSM Associates, Sinclair Securities Company, and APEX Associates. During the years 1979, 1980, and 1981, Mr. Crowley earned more than $380,000 in commissions.

Petitioner and Mr. Crowley entered into a settlement agreement with respondent that provides that petitioner and Mr. Crowley may deduct 20 percent of the losses attributable to the commodities straddle transactions for the years in issue, subject to petitioner's right to contest her liability for the taxes arising out of the settlement pursuant to section 6013(e). The settlement agreement contains standard settlement terms offered by

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6. Petitioner concedes that she is liable for the addition to tax for failure to file timely with respect to that return, unless she is relieved from such liability as an innocent spouse.

respondent to all taxpayers involved in the Arbitrage Management tax shelter litigation project.

Discussion

The decision to grant a motion for reconsideration rests within the discretion of the Court and such a motion will not be granted unless unusual circumstances or substantial error is shown. *Vaughn v. Commissioner*, 87 T.C. 164, 166-167 (1986). Moreover, it is our policy to try all of the issues raised in a case in one proceeding in order to avoid piecemeal and protracted litigation. *Alexander v. Commissioner*, 95 T.C. 467, 469 (1990).

Petitioner contends in her motion for reconsideration that we incorrectly held in our prior Opinion that the understatements in issue were not attributable to "grossly erroneous items". However, before deciding whether petitioner would be entitled to relief from liability as an innocent spouse if we were to accept that contention, we shall consider whether petitioner fails to satisfy any of the other requirements for innocent spouse relief under section 6013(e) that were contested,[7] tried, and briefed by the parties but were not addressed in our prior Opinion. The present record in the instant case is sufficient for us to decide the other undecided requirements for innocent spouse relief under section 6013(e).[8] For the reasons set forth below, we

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7. Respondent concedes that petitioner meets certain of the requirements for relief as an innocent spouse provided by sec. 6013(e).

8. Petitioner requests that we reopen the record to permit her to introduce, inter alia, her transcript from the University of Guelph to show that she took no courses in any tax, business, or financial subject, majored in English, and was "an extremely indifferent student". Petitioner contends that, after the trial of the instant case, the Count of Appeals for the Second

(Cont'd)

conclude that petitioner has failed to satisfy all of the requirements for relief as an innocent spouse provided by section 6013(e) and has failed to satisfy all of the transitional rule requirements as well. Accordingly, we need not reconsider the holding of our prior Opinion that the deductions claimed on the returns for the taxable years in issue are "grossly erroneous items" within the meaning of section 6013(e)(2)(B).[9]

(Cont'd)

Circuit announced a requirement for innocent spouse relief that a taxpayer's education be taken into account in deciding whether the taxpayer knew or had reason to know of the existence of a substantial understatement under sec. 6013(e)(1)(C). *Friedman v. Commissioner*, 53 F.3d 523, 531-532 (2d Cir. 1995), affg. in part, revg. in part, and remanding T.C. Memo. 1993-549; *Hayman v. Commissioner*, 992 F.2d 1256 (2d Cir. 1993), affg. T.C. Memo. 1992-228. Petitioner argues that the "new" requirement renders relevant petitioner's university transcript and the other evidence she seeks to admit and that such relevance could not have been anticipated at the time of such trial. Petitioner admits, however, that the requirement for innocent spouse relief adopted by the Second Circuit had been articulated by other courts prior to the trial of the instant case. See, e.g., *Price v. Commissioner*, 887 F.2d 959, 965 (9th Cir. 1989), revg. an Oral Opinion of this Court.

We do not agree with petitioner that she could not have been aware of the relevance of the evidence she now seeks to introduce simply because the Court of Appeals for the Second Circuit, at the time the instant case was tried, had yet to issue its opinions requiring that a taxpayers education level be taken into consideration. Moreover, petitioner contends that, even without such evidence, the record developed at the trial of the instant case is sufficient to support a finding that she did not know and had no reason to know of the existence of the substantial understatements in issue. We accordingly will not reopen the record to admit additional evidence with respect to the requirements of sec. 6013(e)(1)(C).

9. As to petitioner's allegation that respondent's counsel violated (Cont'd)

Appendix C

Our first consideration is whether, for taxable years 1980 and 1981, petitioner has established the requirements of section 6013(e)(1)(C) that, in signing each of the returns for those years, "she did not know, and had no reason to know," that a substantial understatement of tax exists as to each such return. Respondent contends that petitioner has failed to establish, inter alia, that she did not know and had no reason to know of the substantial understatements in issue when she signed the returns for the taxable years in issue, and that petitioner therefore is not entitled to relief as an innocent spouse. We agree.

The Court of Appeals for the Second Circuit, the court to which an appeal in the instant case would lie, interprets subsection 6013(e)(1)(C) as requiring a taxpayer to establish that " 'she [or he] did not know and did not have reason to know that the deduction would give rise to a substantial understatement.' " *Hayman v. Commissioner*, 992 F.2d 1256, 1261 (2d Cir. 1993), (quoting *Price v. Commissioner*, 887 F.2d 959, 963 (9th Cir. 1989), revg. an Oral Opinion of this Court), affg. T.C. Memo. 1992-228.

In the instant case, respondent contends that petitioner knew that the deductions in issue would give rise to substantial understatements when she signed the returns for the taxable years in issue. Respondent relies primarily on the testimony of

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Rule 201 and rule 3.3(a)(3) of the Model Rules, the misconduct asserted by petitioner relates only to evidence potentially pertinent to the "grossly erroneous items" issue. Because we hold that petitioner is otherwise not entitled to relief under sec. 6013(e), and, because of such holding, do not reconsider our prior holding with respect to the "grossly erroneous items" issue, we need not, and we do not, address that allegation in disposing of the instant motion.

Robert Kraft to support such contention. During the trial of the instant case, Mr. Kraft testified that he had received a law degree from Georgetown University Law Center. At a subsequent hearing, Mr. Kraft admitted that he has never received a law degree. In light of Mr. Kraft's admission, we regard his testimony as inherently untrustworthy and, therefore, do not accept his testimony. Respondent also argues that, because petitioner was a stockbroker who had passed the "series seven" stockbroker examination prior to the time she signed the returns in issue, she must have been exposed to the mechanics of commodities straddle transactions. Respondent, therefore, contends that petitioner knew that the deductions claimed on the returns for the taxable years in issue would give rise to substantial understatements. Nothing in the record, however, establishes that petitioner's studies or her work as a stockbroker exposed her to the intricacies of commodities straddle transactions.[10] Accordingly, we find that petitioner, when she signed the returns for the taxable years in issue, did not have actual knowledge that the deductions would give rise to the substantial understatements.

Even if a taxpayer does not have actual knowledge that deductions claimed on a return would give rise to a substantial understatement, a taxpayer who has reason to know of such an understatement is not entitled to innocent spouse relief. Sec. 6013(e)(1)(C). At the trial of the instant case, petitioner admitted

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10. At trial, respondent offered the testimony of several witnesses in an attempt to establish that the brokerage firm at which petitioner was employed during 1980 and 1981 routinely taught its stockbroker trainees about commodities straddle transactions. The testimony of respondent's witnesses, however, does not establish that petitioner received detailed instruction concerning commodities straddle transactions as a part of her training.

that she signed the returns for the taxable years in issue without reviewing them. Nevertheless, she is charged with constructive knowledge of their contents. *Hayman v. Commissioner*, *supra* at 1262. Petitioner was educated and should have realized her responsibility for reviewing the returns she signed. Consequently, petitioner's failure to review returns that she signed under penalties of perjury cannot be excused. *Terzian v. Commissioner*, 72 T.C. 1364, 1170-1171 (1979).

The Court of Appeals for the Second Circuit has held that the magnitude of the deductions claimed on a return may give rise to a duty to inquire as to the propriety of the deductions. *Friedman v. Commissioner*, 53 F.3d 523, 531 (2d Cir. 1995), (citing *Hayman v. Commissioner*, *supra)*, any, in part and revg. in part and remanding T.C. Memo. 1993-549. The duty of inquiry generally arises with respect to "tax returns setting forth large deductions, such as tax shelter losses offsetting income from other sources and substantially reducing or eliminating the couple's tax liability". *Hayman v. Commissioner*, *supra* at 1262.

In the instant case, we believe that even a cursory review of the returns for the taxable years in issue would have alerted petitioner to the high probability that such returns contained substantial understatements. The 1980 return reported a gain of $408,097 on Schedule D that was offset by a loss of $407,884 reported on Schedule E, which included a loss of $508,045 from TSM Associates. That return reported adjusted gross income of only $8,055 for the taxable year 1980, and tax due of $240.[11] The 1981 return, which was filed untimely on January 31, 1983, reported a gain of $697,896 on Schedule D that was offset by a loss of $679,327 reported on Schedule E, which included a loss

11. During 1980, Mr. Crowley earned $122,683 in commissions from Sinclair Securities Company.

of $413,765 from TSM Associates and a loss of $399,489 from APEX Associates. That return reported adjusted gross income of $90,658, and tax due of $13,980.[12] Both the income and deductions with respect to Mr. Crowley's commodities straddle transactions reported on the 1980 and 1981 returns were larger than the other income and deductions reported by Mr. Crowley and petitioner. Under such circumstances, petitioner had a duty to look into the propriety of the deductions taken on the returns in issue, a duty she has failed to satisfy in the instant case.[13] *Id.* Petitioner cannot obtain the benefits of section 6013(e) by simply turning a blind eye to facts that would reasonably put her on notice that further inquiry would need to be made *Bokum v. Commissioner,* 94 T.C. 126, 148 (1990), affd. 992 F.2d 1132 (11th Cir. 1993). As we have precariously noted, section 6013(e) is designed to protect the innocent, not the intentionally ignorant. *Shannon v. Commissioner*, T.C. Memo. 1991-207.

In deciding whether petitioner "had reason to know" of the substantial understatements when she signed the returns, we also take into account the factors that the Court of Appeals for the Second Circuit has held are to be considered in making such a decision: (1) The spouse's level of education; (2) the spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when

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12. During 1981, Mr. Crowley earned $148,141 in commissions from Sinclair Securities Company.

13. Petitioner, however, contends that the tax returns for the taxable years in issue "indicated a roll of income from prior years to future years, leading an objective observer to conclude that any disallowance would wipe out all income and deductions relating to the transactions resulting in little or no net tax effect." Such a consideration is not a substitute for the inquiry required by the information disclosed on the returns in issue.

compared with the family's past levels of income, standard of living, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning their finances. *Friedman v. Commissioner*, *supra* at 531-532 (citing *Hayman v. Commissioner*, *supra* at 1261). The foregoing factors are considered "because, ordinarily, they predict what a prudent person would realize regardless of the other spouse's evasiveness or deceit." *Bliss v. Commissioner*, 59 F.3d 374, 379 (2d Cir. 1995), affg. T.C. Memo. 1993-390.

Applying such factors to the facts of the instant case, we conclude that petitioner had reason to know of the substantial understatements when she signed the returns for the taxable years in issue. Petitioner was a college-educated stockbroker who had passed the "series seven" examination. She was a former life insurance agent. Petitioner's involvement in the couple's business and financial affairs was also significant. Petitioner knew that Mr. Crowley was a "commodities trader". She traveled with him to several commodities seminars, where she attempted to attract clients for her husband at the hospitality suites provided by his employer after those seminars. They routinely entertained Mr. Crowley's clients at their apartment. Petitioner and Mr. Crowley lived lavishly during 1980 and 1981, the years for which petitioner seeks relief as an innocent spouse. They frequently dined at expensive restaurants during those years. During 1980, they vacationed in Canada, Vermont, and Florida. Mr. Crowley's American Express bill for that year was approximately $90,000, and a substantial portion of that amount was charged by petitioner. During 1981, petitioner and Mr. Crowley rented a two-bedroom apartment in Manhattan for approximately $1,400 or $1,500 per month and garaged Mr. Crowley's BMW automobile for approximately $250 to $300 per month. Finally, there is no evidence in the record that shows

that Mr. Crowley was evasive or deceitful about their finances or that he attempted to conceal the fact that he had engaged in commodities straddle transactions.[14] Based on the record in the instant case, we conclude that, at the time she signed the returns for the taxable years in issue, petitioner had reason to know of the substantial understatements in issue.

Petitioner contends that the Court of Appeals' decision in *Friedman v. Commissioner, supra,* "limits" *Hayman v. Commissioner, supra,* with respect to the "reason to know" requirement of subsection 6013(e)(1)(C). Petitioner interprets the Court of Appeals' decision in *Friedman v. Commissioner, supra,* to mean that the mere fact that a large deduction was claimed from an investment partnership does not cause the alleged innocent spouse to have reason to know of the substantial understatement, where the spouse relied upon representations from her husband that such deduction was proper and where

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14. The Court of Appeals for the Second Circuit recently stated:

> According to the dissent, the petitioner should be deemed innocent because she is guileless and may not have understood why * * * [her ex-husband] should have reported his full income. This misapprehends the nature of innocence in the context of this statute. Innocent people pay taxes; the obligation to pay taxes rests on liability, not guilt. An innocent spouse within the meaning of [sec. 6013(e)] is innocent vis-a-vis a guilty spouse whose income is concealed from the innocent and spent outside the family. [*Bliss v. Commissioner,* 59 F.3d 374, 380 n.3 (2d Cir. 1995), affg. T.C. Memo. 1953-390.]

As in *Bliss v. Commissioner, supra,* there is no evidence in the record that suggests that Mr. Crowley was evasive or deceitful with respect to their finances or that he attempted to conceal the fact that he had engaged in commodities straddle transactions.

the taxpayer was not very sophisticated in financial matters. According to petitioner, when she signed the tax returns for the taxable years in issue, she was young and very unsophisticated in financial matters, having just arrived from Canada.

We disagree with petitioner's interpretation of *Friedman v. Commissioner, supra*, as well as her characterization of herself as unsophisticated with respect to financial matters. In *Friedman v. Commissioner, supra*, the Court of Appeals applied the knowledge standard that it adopted in *Hayman v. Commissioner, supra*. In *Friedman v. Commissioner, supra*, however, the taxpayer was a "housewife and unemployed former secretary with a high school education possessing only a rudimentary grasp of the simplest tax principles." *Friedman v. Commissioner*, 53 F.3d at 530.[15] The Court of Appeals held that the taxpayer in *Friedman v. Commissioner, supra* at 531, satisfied her duty of inquiry when she asked her former husband about the deductions that gave rise to the understatements, and he told her that "they resulted from a tax shelter and for her not to worry." In so holding, the Court of Appeals relied on the fact that the taxpayer knew that the returns in question had been prepared by an accountant, who was also a trusted personal friend of the family, and that the tax shelter had been recommended to her former husband by a tax expert, with whose reputation she was familiar through her past employment in her husband's business.

Petitioner, unlike the taxpayer in *Friedman v. Commissioner,*

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15. The facts of the instant case are more analogous to those of *Hayman v. Commissioner*, 992 F.2d 1256, 1258 (2d Cir. 1993), affg. T.C. Memo. 1992-228, which involved a "highly-paid, college-educated vice-president and merchandising director employed by the well-known women's clothing chain, Ann Taylor". *Friedman v. Commissioner*, 53 F.3d 523, 530 (2d Cir. 1995), (citing *Hayman v. Commissioner, supra* at 1258), affg. in part and revg. in part T.C. Memo. 1993-549.

supra, was a college-educated stockbroker when she signed the returns in issue, who admits that she failed to review those returns prior to signing them. Petitioner's failure to review the returns before signing them was apparently deliberate because nothing in the record indicates that she could not have reviewed them had she wished to do so. Petitioner claims that she signed the returns because she trusted Mr. Crowley. That trust alone, however, does not eliminate a spouse's duty to inquire when a perusal of the return would indicate that further inquiry is necessary. *Hayman v. Commissioner*, *supra* at 1262; *Stevens v. Commissioner*, 872 F.2d 1499, 1507 (11th Cir. 1989), affg. T.C. Memo. 1988-63. Consequently, we hold that petitioner has failed to prove that she did not know and had no reason to know that the deductions claimed on the returns for the taxable years in issue would give rise to substantial understatements.[16]

Turning to petitioner's contention that she is eligible for relief as an innocent spouse under the transitional rule,[17] we

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16. Our holding renders it unnecessary to consider whether petitioner has satisfied the remaining contested requirement of sec. 6013(e).

17. In *Park v. Commissioner*, 25 F.3d 1289, 1300 (5th Cir. 1994), affg. T.C. Memo. 1993-252, the Court of Appeals for the Fifth Circuit addressed the scope of the transitional rule as follows:

> a reading of the transitional rule in conjunction with section 6013(e) reveals that Congress did intend for the transitional rule to provide broader innocent spouse relief under limited circumstances to a certain class of spouses — i.e., those who filed joint returns with substantial understatements prior to January 1, 1985, and whose marriages had since terminated. See *Thompson*, 63 T.C.M. (CCH) at 2884. For such spouses,

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note that petitioner could have raised the issue of her eligibility for relief under that provision in the prior proceedings in the instant case. We also note that TAMRA, which included the transitional rule, was enacted November 10, 1988, 102 Stat. 3812, well before the instant case was tried. As noted above, it is the policy of this Court to try all of the issues raised in a case in one proceeding in order to avoid piecemeal and protracted litigation. *Alexander v. Commissioner*, 95 T.C. at 469. In the interest of judicial efficiency, we generally will not grant a motion for reconsideration to resolve issues that could have been raised during prior proceedings. *CWT Farms, Inc. v. Commissioner*, 79 T.C. 1054, 1057 (1982); *Robin Haft Trust v. Commissioner*, 62 T.C. 145, 147 (1974), affd. on this issue, 510 F.2d 43, 45 n.1 (1st Cir. 1975).

We note that the transitional rule does provide, in pertinent part, the following:

> "(D) without regard to any determination before October 21, 1988, the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such an understatement

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Congress eliminated the requirement under section 6013(e)(1)(D), which required a spouse to show that it would be inequitable to hold her liable for the understatement. In its place Congress instituted a "net worth" test, relieving the spouse from liability if she met the "no reason to know" requirement and had a net worth of less than $10,000 immediately after the termination of the marriage. Thus, under the transitional rule, unlike under section 6013(e), Congress afforded innocent spouse relief to a spouse who had benefitted from an erroneous deduction as long as after the termination of the marriage her net worth was less than $10,000.

Appendix C

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> *notwithstanding any law or rule of law* (*including res judicata*), the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such understatement, * * *. [TAMRA sec. 6004, 102 Stat. 3685; emphasis added.]

The Court of Appeals for the Fifth Circuit has found that the purpose of the foregoing language is to enable a taxpayer, who meets the requirements of the transitional rule, to be relieved of liability for an understatement as an innocent spouse notwithstanding a decision as to the taxpayer's liability prior to the enactment of the transitional rule. *Park v. Commissioner*, 25 F.3d 1289, 1300 (5th Cir. 1994), affg. T.C. Memo. 1993-252. Similarly, another court has concluded that the foregoing provisions were intended to make the relief afforded by the transitional rule "available to a person who did not have its benefit when her case was determined". *In re Freytag*, 173 Bankr. 330, 334 (N.D. Tex. 1994). We, however, do not need to decide whether the foregoing language of the transitional rule requires us to resolve the question whether petitioner qualifies for relief as an innocent spouse under the transitional rule where it was first raised in a motion for reconsideration and could have been raised in prior proceedings. Even were we to consider petitioner's claim for relief under the provisions of the transitional rule, we would nevertheless conclude that she does not satisfy its requirements.

As with the requirements for relief under section 6013(e), a taxpayer must establish that all of the conditions imposed by the transitional rule are satisfied in order to be eligible for relief

under that rule. *Park v. Commissioner, supra* at 1300. We have held above that petitioner did not satisfy the knowledge requirement of section 6013(e)(1)(C), in that she did not establish that, in signing the returns in issue, she "did not know, and had no reason to know" of the understatements in issue. Recently, in *Park v. Commissioner, supra* at 1300, the Court of Appeals for the Fifth Circuit concluded that

> The "did not know, and had no reason to know" language of the transitional rule virtually mirrors that of section 6013(e), suggesting that Congress intended the "no reason to know" requirement of both provisions to have the same meaning.

Consequently, in order to obtain relief under the transitional rule, petitioner must, under subparagraph (D) of that rule, make the same showing that she is required to make under section 6013(e)(l)(C). Petitioner has failed show that she satisfies the test of subsection 6013(e)(1)(C) and therefore would also fail to establish that she satisfies the test of subparagraph (D) of the transitional rule. Accordingly, petitioner could not find relief as an innocent spouse under the provisions of the transitional rule.

To reflect the foregoing,[18]

Appropriate orders will be issued.

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18. Although we sympathize with petitioner's plight, we are guided by the statement we made in *Sonnenborn v. Commissioner,* 57 T.C. 373, 380-381 (1971):

> The filing of a joint return is a highly valuable privilege to husband and wife since the resulting tax liability is generally substantially less than the combined taxes that would be due

(Cont'd)

Appendix C

(Cont'd)

> from both spouses if they had filed separate returns. This circumstance gives particular emphasis to the statutory rule that liability with respect to tax is joint and several, regardless of the source of the income or of the fact that one spouse may be far less informed about the contents of the return than the other, for both spouses ordinarily benefit from the reduction in tax that ensues by reason of the joint return. However, some highly inequitable results were called to the attention of Congress, particularly where a wife had been divorced or separated or abandoned after the tax year, where she was saddled with a disproportionately high tax liability as a consequence of having filed a joint return, where such liability grew out of income attributable only to the husband, unknown to the wife, and where she had not enjoyed any benefit therefrom. It was in an effort to eliminate the unfairness of the joint and several liability provisions in such circumstances that section 6013(e) was enacted. To be sure, section 6013(e) is not limited to precisely such narrow situations. But it must be kept in mind that Congress still regards joint and several liability as an important adjunct to the privilege of filing joint returns, and that if there is to be any relaxation of that rule the taxpayer must comply with the carefully detailed conditions set forth in section 6013(e). [Fn. ref. omitted]

In the instant case, we are, of course, bound to apply the law that Congress enacted. If the result we reach seems harsh, the remedy must lie with Congress, which is the body that has the power to relax the requirements for obtaining relief as an innocent spouse.

APPENDIX D — MEMORANDUM FINDINGS OF FACT AND OPINION OF THE UNITED STATES TAX COURT FILED NOVEMBER 1, 1993

[¶93,503] TC Memo 1993-503. JOHN P. CROWLEY AND ELIZABETH R. COCKRELL. Docket Nos. 28826-84, 7746-87. 11-01-93. Opinion by Wells, *J.* Years 1980-1981. Decision for Commissioner.

1. Joint returns. Taxpayer could file joint return with her husband because she was U.S. resident during taxable year, and was jointly liable for deficiency because she didn't qualify as innocent spouse. Taxpayer wasn't nonresident alien: she resided and was employed in U.S. during tax year; applied for permanent residency and received green card; and only had indefinite intention to return to Canada. Further, taxpayer wasn't entitled to innocent spouse relief because she failed to prove that reductions taken for losses incurred in commodities straddle transactions were attributable to "grossly erroneous items." Former husband's testimony that disallowed reductions involved tax-shelter transactions didn't establish that deductions had no basis in fact or law; and, fact that IRS agreed to compromise settlement, with higher interest rate applying to part of deficiencies, didn't show that claimed deductions were grossly erroneous items. *Reference:* United States Tax Reporter ¶60,135.05(7); 60,135.01(35). IRC §6013.

Official Report

Stanley Klein and Michael J. Weitzner, for petitioner John P. Crowley at docket No. 28826-84.

Gerald N. Daffner, for petitioner Elizabeth R. Cockrell at docket Nos. 28826-84 and 7746-87.

Roland Barral and William L. Blagg, for respondent.

Appendix D

MEMORANDUM FINDINGS OF FACT AND OPINION

WELLS, *Judge:* In docket No. 28826-84 respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Against petitioner John P. Crowley:

Year	Deficiency
1976	$ 52,437
1977	11,913
1978	31,302

Against petitioners:

Year	Deficiency
1979	$ 104,908
1980	337,115

In Docket No. 7746-87, respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Year	Deficiency
1981	$543,191

*50 Percent of the interest due on $543,191.

	Additions to Tax	
Sec. 6651(a)	Sec. 6653(a)(1)	Sec. 6653(a)(2)
$137,443	$27,858	*

The instant cases were consolidated for purposes of trial, briefing and opinion (hereinafter referred to as the instant case).

Appendix D

The parties have settled certain issues with respect to petitioner John P. Crowley. The parties have agreed to reduce the deficiencies to $338 for the taxable year 1977 and $6,967 for the taxable year 1978. There is no deficiency for the taxable year 1976. The parties have also settled certain issues with regard to both petitioners and, subject to our decision on the issues set forth in this Opinion with respect to petitioner Elizabeth R. Cockrell, have agreed to reduce petitioners' deficiencies to $21,250 for taxable year 1979, $45,563 for taxable year 1980, and $93,810 for taxable year 1981. Petitioners have also agreed to be liable for an addition to tax under section 6651(a)(1).[1] Respondent conceded the additions to tax under section 6653(a)(1) and (2) for the taxable year 1981. The parties have stipulated that for taxable years 1978, 1979, and 1980, $3,484, $10,760, and $22,826, respectively, are substantial underpayments attributable to tax motivated transactions, for purposes of computing the interest payable with respect to such amounts, pursuant to section 6621(c).

The following issues remain for decision: (1) Whether petitioner Elizabeth R. Cockrell was a "nonresident alien," within the meaning of section 6013(a)(1) for any portion of the 1980 taxable year;[2] and (2) whether she is entitled to "innocent spouse" relief under section 6013(e) for taxable years 1980 and 1981. As petitioner John P. Crowley has settled all issues in the instant case with respect to himself, hereinafter we will refer to

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1. All section references are to the Internal Revenue Code as in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

2. Respondent conceded that petitioner was a nonresident alien during the taxable year 1979. Consequently, petitioner is not jointly liable for the deficiency for the 1979 taxable year.

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Elizabeth R. Cockrell as "petitioner" and John P. Crowley as Mr. Crowley.

FINDINGS OF FACT

When they filed petitions, petitioner and Mr. Crowley were residents of New York, New York.

On November 14, 1979, petitioner and Mr. Crowley were married. At that time, petitioner was a Canadian citizen and Mr. Crowley was a U.S. citizen. They were married in a New York civil ceremony. On November 17, 1979, petitioner and Mr. Crowley were married a second time in a Canadian church. After the wedding and before returning to New York, they traveled to St. Martin and Colorado. Petitioner did not live in the United States prior to her marriage. During August 1979, just prior to her marriage to Mr. Crowley, petitioner quit her job, gave up the lease to her apartment, and resided in Canada with her brother.

Petitioner and Mr. Crowley discussed the possibility of moving to Canada after their marriage. During the early part of 1980, Mr. Crowley had an interview with at least one potential Canadian employer and also discussed the possibility of opening a Canadian office with his own employer at that time. Petitioner and Mr. Crowley, however, did not make any definite plans to move to Canada, and Mr. Crowley remained employed in New York.

During February 1980, petitioner completed and filed an application for status as a permanent resident. On March 31, 1980, petitioner appeared before the Immigration and Naturalization Service (INS). On April 17, 1980, the INS issued

petitioner a "green card," which petitioner had sought in order to travel to Canada and return to the United States without difficulty.

During 1980, petitioner worked for a photographer in New York City for 1 week in exchange for learning about photography. For 2 weeks, she solicited, by telephone, on behalf of a messenger service located in New York City, for which she was compensated approximately $200.

During December 1980, petitioner was hired as a stockbroker trainee in New York. In order to prepare for the series seven stockbroker examination required for her employment, petitioner studied about stocks and bonds at home. Prior to passing the exam, petitioner answered the phones at work. During the early part of 1981, petitioner passed the exam and obtained her stockbroker license. Subsequently, petitioner "cold-called" potential clients to sell them stocks and bonds. Neither petitioner's studies nor her work specifically included commodities tax straddles.

During the years in issue, Mr. Crowley was a partner in TSM Associates, Sinclair Securities Company, and APEX Associates, which were partnerships that had engaged in commodities straddle transactions involving Treasury bill options. Mr. Crowley, as an employee in James Sinclair Trading Corporation, arranged commodities straddle transactions for investors seeking "tax-sheltered investments."

Petitioner was aware of Mr. Crowley's position as a "commodities trader." Petitioner accompanied Mr. Crowley at several commodities seminars during which she "milled about" at the back of the room, "drifted" in and out of the seminar

rooms, and socialized with other wives attending the seminars. Petitioner attempted to attract clients for her husband at the hospitality suites provided by Mr. Crowley's employer. Petitioner, however, did not discuss commodities straddles transactions during the seminars or in the hospitality suites.

When petitioner and Mr. Crowley were first married they rented a one-bedroom apartment in Manhattan. During 1981, they moved to a two-bedroom apartment which they rented for approximately $1,400 or $1,500 per month. Subsequently, they rented a ranch house on Long Island. Because they experienced marital difficulties, however, they returned to New York City. During 1982, petitioner and Mr. Crowley decided to separate. After their separation, petitioner moved into a small loft apartment and paid the security deposit with $2,000 which Mr. Crowley had given her. On August 18, 1983, petitioner and Mr. Crowley were divorced.

On June 15, 1980, petitioner and Mr. Crowley signed a joint tax return for taxable year 1979, which was filed on June 24, 1980, and reported a negative adjusted gross income in the amount of $71,312. On June 15, 1981, petitioner and Mr. Crowley signed a joint return for taxable year 1980, which was filed before the end of the month and reported an adjusted gross income of $8,055. On January 26, 1983, petitioner and Mr. Crowley signed a joint return for taxable year 1981, which was filed on January 31, 1983, and reported an adjusted gross income of $90,658. The losses disallowed in the notices of deficiency were claimed by petitioner and Mr. Crowley on their 1979, 1980, and 1981 returns as Mr. Crowley's share of the losses incurred by TSM Associates, Sinclair Securities Company, and APEX Associates. During the years 1979, 1980, and 1981, Mr. Crowley earned more than $380,000.

Appendix D

Petitioner and Mr. Crowley entered a settlement agreement with respondent which provides that petitioner and Mr. Crowley may deduct 20 percent of the losses attributable to the commodities straddle transactions for the years in issue. The settlement contains the standard settlement terms offered by respondent to all taxpayers involved in the Arbitrage Management tax shelter litigation project.

OPINION

The first issue we must decide is whether petitioner was a "nonresident alien" within the meaning of section 6013(a)(1) for any portion of the 1980 taxable year. Section 6013(a)(1) provides that a joint return shall not be made "if either the husband or wife at any time during the taxable year is a nonresident alien." Section 6013, however, does not define the term "nonresident alien." Section 1.871-2(a), Income Tax Regs., states: "The term 'nonresident alien individual' means an individual whose residence is not within the United States and who is not a citizen of the United States." For the years in issue, section 1.871-2(b), Income Tax Regs., provides:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intentions as to his stay, he is a resident.

The regulations also provide that an alien by reason of his

or her status as an alien is presumed to be a nonresident, but such presumption may be rebutted by "acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident." Sec. 1.871-4, Income Tax Regs.

The effect of the presumption is to relieve petitioner from having to establish at the outset that she is a nonresident alien. The burden of proof, however, remains on petitioner. Park v. Commissioner, 79 T.C. 252, 288 n.13 (1982), affd. without opinion 755 F.2d 181 (D.C. Cir. 1985); Lemery v. Commissioner, 54 T.C. 480, 486 (1970); Adams v. Commissioner 46 T.C. 352, 361 n.8 (1966). Consequently, respondent must come forth with evidence that petitioner is a resident in order to rebut such presumption.

Residency is a question of fact which must be resolved by considering all the relevant facts and circumstances. Park v. Commissioner, supra at 286; Adams v. Commissioner, supra at 358; Jellinek v. Commissioner, 36 T.C. 826, 834 (1961). The term "residency" does not have the same meaning as "domicile", but to be a resident requires the taxpayer to have some "degree of permanent attachment for the country of which he is an alien." Jellinek v. Commissioner, supra at 834.

In the instant case, the record establishes that petitioner resided in the United States during 1980. The record also establishes that, although petitioner and Mr. Crowley had discussed the possibility of returning to Canada, such discussion was nothing more than a "floating intention, indefinite as to time," which is insufficient to treat petitioner as a transient nonresident. Sec. 1.871-2(b), Income Tax Regs. We base our

conclusion upon the fact that petitioner resided in the United States during the entire year and was employed in New York City. Moreover, she applied for status as a permanent resident and was issued a green card during early 1980. In our view, such evidence rebuts the presumption of nonresidency. Furthermore, nothing in the record persuades us that petitioner had anything other than a floating, indefinite intention to return to Canada. Consequently, we hold that petitioner was a resident of the United States during 1980 and was entitled to file a joint return with Mr. Crowley. Accordingly, petitioner is jointly liable for the deficiency for taxable year 1980, unless she qualifies as an innocent spouse.

We must next decide whether petitioner qualifies as an innocent spouse under section 6013(e) for taxable years 1980 and 1981. To qualify for innocent spouse status, the spouse seeking relief must satisfy all of the requirements of section 6013(e), which provides relief only when: (1) A joint return has been made for the taxable year; (2) a substantial understatement of tax attributable to grossly erroneous items of one spouse is found on such return; (3) the other spouse establishes that he or she did not know, and had no reason to know, of the existence of such substantial understatement; and (4) it is inequitable to hold such spouse liable for the deficiency in tax attributable to such substantial understatement. Petitioner has the burden of proving each requirement of section 6013(e). Rule 142(a); Russo v. Commissioner, 98 T.C. 28, 31-32 (1992). Failure to prove any one of the requirements will preclude the spouse from relief. Purcell v. Commissioner, 826 F.2d 470, 473 [60 AFTR2d 87-5516] (6th Cir. 1987), affg. 86 T.C. 228 (1986); Bokum v. Commissioner, 94 T.C. 126, 138 (1990), affd. 992 F.2d 1132 [72 AFTR2d 93-5111] (11th Cir. 1993); Estate of Krock v. Commissioner, 93 T.C. 672, 677 (1989).

Appendix D

In the instant case, respondent concedes that a joint return was filed by petitioner in each of the years in issue and that a substantial understatement of tax exists within the meaning of section 6013(e)(3) and (4). Respondent, however, contends that such understatement was not attributable to a "grossly erroneous item." Section 6013(e)(2) defines a grossly erroneous item as:

> (A) any item of gross income attributable to such spouse which is omitted from gross income, and
>
> (B) any claim of a deduction, credit or basis by such spouse in an amount for which there is no basis in fact or law.

The phrase "no basis in fact or law," is not defined in section 6013. The courts, however, have held that a deduction has no basis in fact when the expense for which the deduction is claimed was never in fact made and a deduction has no basis in law when the expense, even if made, does not qualify as a deductible expense under well settled legal principles or when no substantial legal argument can be made to support its deductibility. Ness v. Commissioner, 954 F.2d 1495, 1498 [69 AFTR2d 92-537] (9th Cir. 1992), revg. 94 T.C. 784 (1990); Douglas v. Commissioner, 86 T.C. 758, 762-763 (1986).

To prove that the disallowed deductions have no basis in fact or law, an individual seeking innocent spouse status is not entitled to rely on the Commissioner's disallowance of deductions contained in the notice of deficiency, without introducing further evidence to establish that a deduction has no basis in fact or law. Douglas v. Commissioner, supra at 763; Rampulla v. Commissioner, T.C. Memo. 1993-504 [1993 RIA TC Memo ¶93,504]; Feldman v. Commissioner, T.C. Memo. 1993-17 [1993 RIA TC Memo ¶93,017]; Anthony v.

Commissioner, T.C. Memo. 1992-133 [1992 RIA TC Memo ¶92,133]; Cohen v. Commissioner, T.C. Memo. 1991-413 [1991 TC Memo ¶91,413], Neary v. Commissioner, T.C. Memo. 1985-261 [¶85,261 PH Memo TC].

Petitioner has not offered any evidence that would support a finding that the losses claimed on the 1980 and 1981 returns have no basis in fact or law. The losses claimed on the returns arise out of certain straddle transactions of partnerships in which Mr. Crowley invested. To be entitled to deduct such losses Mr. Crowley would have been required to show that the partnerships engaged in the commodities straddle transactions primarily for the purpose of profit. Fox v. Commissioner, 82 T.C. 1001, 1021 (1984). In Fox v. Commissioner, supra, we held that the issue of whether the taxpayer engaged in commodities straddle transactions for the primary purpose of profit is a question of fact which involves an examination of all the circumstances surrounding the transactions in issue.[3] Id. at 1022.

3. In 1984 Congress granted amnesty for pre-1981 straddle transactions. Sec. 108(a) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630 as amended by sec. 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817-2818 (hereinafter referred to as amended sec. 108). In order to qualify for relief under amended sec. 108 of the Deficit Reduction Act of 1984 a loss on a disposition of a position is deductible if the position (1) is part of a straddle, (2) was entered into before 1982, (3) is not subject to the rules enacted in 1981, and (4) is a "transaction entered into for profit though not connected with a trade or business." In Boswell v. Commissioner, 91 T.C. 151 (1988), we held that under amended sec. 108, losses relating to commodities straddle transactions entered into before June 23, 1981, are deductible if the taxpayer's primary motive for engaging in the transactions was to realize an economic profit. In the instant case, because petitioner has failed to provide us with any information concerning the underlying transactions, we are unable to ascertain whether Mr. Crowley and petitioner would be entitled to relief under amended sec. 108 of the Deficit Reduction Act of 1984.

Appendix D

In the instant case, the only information in the record concerning the underlying transactions is the testimony of James Sinclair that TSM Associates "was a partnership engaged in speculative trading for the purposes of profit" and the testimony of Mr. Crowley that the disallowed deductions involved tax-sheltered transactions. Clearly, such testimony does not establish any basis for finding that the deductions are without any basis in fact or law.

Petitioner contends that the fact that the parties entered into a compromise settlement is proof that the deductions in question are grossly erroneous items. Under the terms of the stipulated settlement, petitioner and Mr. Crowley were allowed to deduct 20 percent of the losses attributable to the commodities straddle transactions for the years in issue. The stipulations of settled issues filed in the instant case do not disclose the basis for the allowance of 20 percent of the deductions claimed by petitioner and Mr. Crowley. Consequently, we do not think that such compromise shows that the deductions in question were grossly erroneous items. To the contrary, the fact that respondent agreed to a compromise settlement suggests that the deductions in question were less than grossly erroneous. Anthony v. Commissioner, T.C. Memo. 1992-133 [1992 RIA TC Memo ¶92,133]; Neary v. Commissioner, T.C. Memo. 1985-261 [¶85,261 PH Memo TC]. Similarly, the parties' stipulation that an increased rate of interest under section 6621(c) applies to a portion of the deficiencies does not indicate that the claimed deductions are grossly erroneous items. Id.

In short, petitioner has failed to prove that the deductions taken for losses incurred in the commodities straddle transactions have no basis in fact or law. Consequently, we hold that they are not attributable to "grossly erroneous items" within the meaning

of section 6013(e)(2). Accordingly, we hold that petitioner is not entitled to innocent spouse relief under section 6013(e) for the taxable years in issue.

To reflect the foregoing,

Decisions will be entered under Rule 155.